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# Insider Abuse and Criminal Misconduct in Financial Institutions: A Crisis

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## Insider Abuse and Criminal Misconduct in Financial Institutions: A Crisis?

Regulatory agencies<sup>1</sup> are charged with protecting the safety and soundness of the banking industry. Despite those objectives, American financial institutions<sup>2</sup> are currently failing at a rate higher than at any time since the 1930's. Today insider abuse and criminal misconduct<sup>3</sup> contribute to a significant number of financial institution failures.

Occurrences of misconduct have risen to a level labeled by many as a crisis. President Bush recently pledged that "we will make every effort to recover assets diverted from these institutions and to place behind bars those who have caused losses through criminal behavior."<sup>4</sup> Congress has recognized the seriousness of insider abuse and criminal misconduct in

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1 Various government bodies regulate financial institutions in the United States. Both commercial banks and savings and loan associations may have federal or state charters. State regulatory systems cover state chartered financial institutions, while federal agencies regulate federally chartered institutions and some state chartered institutions. There are many jurisdictional overlaps among federal agencies and between federal and state regulators.

This Note focuses on federal regulation. To promote efficient regulation and to minimize duplicate efforts, federal banking agencies concentrate on certain institutions. The Federal Reserve System possesses the authority to supervise all banks which are members of that system but concentrates its supervisory powers on state chartered member banks. N. LASH, *BANKING LAWS AND REGULATIONS: AN ECONOMIC PERSPECTIVE* 28 (1987). The Federal Deposit Insurance Corporation (FDIC) supervises all banks insured by it but focuses on state chartered banks which are not members of the Federal Reserve System. *Id.* at 29. The Office of the Comptroller of the Currency (OCC) supervises federally chartered or "national" banks. *Id.* at 26.

A similar regulatory system applies to savings and loan associations. The Federal Home Loan Bank Board (FHLBB) supervises federally chartered savings and loan associations. The Federal Savings and Loan Insurance Corporation (FSLIC) insures all federal savings and loan associations and some state chartered associations. The FSLIC supervises insured state chartered savings and loan associations. M. SCHROEDER, *BANK OFFICER'S HANDBOOK OF COMMERCIAL BANKING LAW* ¶ 2.03 (6th ed. 1989).

2 The term "financial institutions" in this Note includes commercial banks and savings and loan associations.

3 This Note defines insider activities as the Subcommittee on Commerce, Consumer, and Monetary Affairs did in its 1984 Report.

'[I]nsider abuse' . . . refers to a wide range of misconduct by officers, directors and insiders of financial institutions committed with the intent to enrich themselves without regard for the safety and soundness of the institutions they control, in violation of civil banking laws and regulations and perhaps also in violation of criminal banking laws. The term 'criminal misconduct' refers strictly to criminal acts committed by such insiders against the institutions they control.

H.R. REP. NO. 1137, 98th Cong., 2d Sess. 2 n.5 (1984).

4 *President's News Conference on Savings Crisis and Nominees*, N.Y. Times, Feb. 7, 1989, at 36, col. 1. Even a coordinated federal effort may not recover a significant amount of the losses caused by insider misconduct. Addressing the issue of fraud losses, Attorney General Richard Thornburgh stated that "[w]e'd be fooling ourselves to think any substantial portion of those assets are going to be recovered, notwithstanding our best efforts." Bartlett, *Savings Fraud Losses Seen As Lost For Good*, N.Y. Times, Feb. 10, 1989, at 29, col. 3. The government can seize assets purchased with the illegally obtained funds, but some funds are "simply not recoverable." *Id.* "In many cases, the fraud involved investments in inflated commercial real estate that is now worthless. In addition, some money may have been taken out of the country." *Id.*

financial institutions, holding hearings<sup>5</sup> on the subject and passing new bank fraud legislation.<sup>6</sup> The United States Justice Department and the federal banking agencies are working together to improve detection, investigation, and prosecution of insider abuse and criminal misconduct in financial institutions.<sup>7</sup> Despite those efforts, the problem of institution failures caused by insider abuse and criminal misconduct remains. A coordinated comprehensive approach to that problem does not exist. Ful-

5 Various congressional committees have investigated the problems of insider abuse and criminal misconduct in financial institutions. The House Subcommittee on Commerce, Consumer, and Monetary Affairs targeted this subject for study. See *Examination and Supervision of Depository Institutions: Hearing Before the House Comm. on Banking, Finance and Urban Affairs*, 101st Cong., 1st Sess. (Jan. 13, 1989); *Adequacy of Federal Efforts to Combat Fraud, Abuse, and Misconduct in Federally Insured Financial Institutions: Hearing Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations*, 100th Cong., 1st Sess. (1987); *Fraud and Abuse by Insiders, Borrowers, and Appraisers in the California Thrift Industry: Hearing Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations*, 100th Cong., 1st Sess. (1987); *Federal Response to Criminal Misconduct By Bank Officers, Directors, and Insiders (Part 2): Hearing Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations*, 98th Cong., 2d Sess. (1984); *Federal Response to Criminal Misconduct by Bank Officers, Directors, and Insiders (Part 1): Hearing Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations*, 98th Cong., 1st Sess. (1983); HOUSE COMM. ON GOVERNMENT OPERATIONS, COMBATING FRAUD, ABUSE, AND MISCONDUCT IN THE NATION'S FINANCIAL INSTITUTIONS: CURRENT FEDERAL EFFORTS ARE INADEQUATE, H.R. REP. NO. 1088, 100th Cong., 2d Sess. (1988); HOUSE COMM. ON GOVERNMENT OPERATIONS, FEDERAL RESPONSE TO CRIMINAL MISCONDUCT AND INSIDER ABUSE IN THE NATION'S FINANCIAL INSTITUTIONS, H.R. REP. NO. 1137, 98th Cong., 2d Sess. (1984).

Additional hearings and reports concern specific financial institution failures: *Golden Pacific National Bank: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 99th Cong., 1st Sess. (1985); *Ohio Savings and Loan Crisis and Collapse of ESM Government Securities, Inc.: Hearing Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations*, 99th Cong., 1st Sess. (1985); *Inquiry into Continental Illinois Corp. and Continental Illinois National Bank: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 98th Cong., 2d Sess. (1984); *Adequacy of Federal Home Loan Bank Board Supervision of Empire Savings and Loan Association: Hearing Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations*, 98th Cong., 2d Sess. (1984); *Federal Supervision and Failure of United American Bank (Knoxville, Tenn.): Hearings Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations*, 98th Cong., 1st Sess. (1983); *Failure of Penn Square Bank: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 97th Cong., 2d Sess. (1982); *Penn Square Bank Failure: Hearings Before the House Comm. on Banking, Finance and Urban Affairs*, 97th Cong., 2d Sess. (1982); *Federal Supervision Failure of the Penn Square Bank, Oklahoma City, Okla.: Hearing Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations*, 97th Cong., 2d Sess. (1982); *The Failure of Citizens State Bank of Carrizo Springs, Texas, and Related Financial Problems: Hearings Before the Subcomm. on Financial Supervision, Regulation and Insurance of the House Comm. on Banking, Currency and Housing*, 94th Cong., 2d Sess. (1976); *Oversight Hearings into the Effectiveness of Federal Bank Regulation (Franklin National Bank Failure): Hearings Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations*, 94th Cong., 2d Sess. (1976); *Oversight Hearings into the Effectiveness of Federal Bank Regulation (Federal Home Loan Bank Board's Supervision of Washington Federal Savings & Loan Association): Hearings Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations*, 94th Cong., 2d Sess. (1976); STAFF OF SUBCOMM. ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND INSURANCE OF THE HOUSE COMM. ON BANKING, FINANCE AND URBAN AFFAIRS, 99TH CONG., 1ST SESS., CONTINENTAL ILLINOIS NATIONAL BANK: REPORT OF AN INQUIRY INTO ITS FEDERAL SUPERVISION AND ASSISTANCE (Comm. Print 1985); HOUSE COMM. ON GOVERNMENT OPERATIONS, FEDERAL HOME LOAN BANK BOARD SUPERVISION AND FAILURE OF EMPIRE SAVINGS AND LOAN ASSOCIATION OF MESQUITE, TEX., H.R. REP. NO. 953, 98th Cong., 2d Sess. (1984); HOUSE COMM. ON GOVERNMENT OPERATIONS, FEDERAL SUPERVISION AND FAILURE OF UNITED AMERICAN BANK IN KNOXVILLE, TENN., AND AFFILIATED BANKS, H.R. REP. NO. 573, 98th Cong., 1st Sess. (1983); HOUSE COMM. ON GOVERNMENT OPERATIONS, ADEQUACY OF THE OFFICE OF THE COMPTROLLER OF THE CURRENCY'S SUPERVISION OF FRANKLIN NATIONAL BANK, H.R. REP. NO. 1669, 94th Cong., 2d Sess. (1976).

6 See *infra* notes 84-90 and accompanying text.

7 See *infra* notes 125-33 and accompanying text.

filling President Bush's pledge will require increased coordination of federal efforts against insider abuse and criminal misconduct in financial institutions.

This Note examines financial institution failures in Part I. Part II discusses enforcement actions applicable to insider misconduct in the banking industry. Part III analyzes efforts to curb insider abuse and criminal misconduct. Part IV concludes that increased cooperation and communication, particularly on regional and local levels, will produce a more effective attack on insider abuse and criminal misconduct in financial institutions.

## I. Failures of Financial Institutions

After thousands of banks failed during the 1920's and early 1930's,<sup>8</sup> the annual number of bank failures plummeted. In the forty-nine years from 1934 to 1982, only 764 banks failed.<sup>9</sup> Recent failure rates, how-

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8 The economic crisis of the 1920's forced 6000 banks to suspend operations or voluntarily liquidate. Four thousand banks were absorbed or merged into other banks. N. LASH, *supra* note 1, at 10. A series of smaller banking crises occurred during the early 1930's. In December of 1930, 352 banks failed. *Id.* at 11. Similar crises occurred in the spring of 1931 and in 1933. The 1933 banking crisis led President Roosevelt to close all banks for a 10 day period. *Id.* at 12.

The economic catastrophe in the United States from 1929 to 1933 is well known. "The number of banks declined from 25,000 to 15,000; the money supply dropped by one-third; and unemployment rose to 25 percent of the labor force." *Id.*

9 C. GOLEMBE & D. HOLLAND, *FEDERAL REGULATION OF BANKING* 1983-84 at 44 (1984). "Bank failure" statistics can be deceptive. The FDIC may pursue various actions when a bank becomes insolvent. Those agency activities determine whether or not statistics include that institution as a failed bank.

The Comptroller of the Currency holds the power to declare a national bank insolvent. 12 U.S.C. § 191 (1982). After determining insolvency, the Comptroller appoints the FDIC as receiver. 12 U.S.C. § 1821(c) (1982). State bank chartering agencies possess the authority to declare a state bank insolvent. After such a declaration, "[t]he FDIC may accept appointment as receiver of an insolvent state bank, and frequently is so requested." C. GOLEMBE & D. HOLLAND, *supra*, at 46.

The FDIC, as receiver, may pay off insured depositors and liquidate the bank's assets. Failed bank statistics include banks subject to deposit payoffs. *Id.* at 45. A deposit payoff, however, carries several disadvantages. The community loses banking services and depositors suddenly hold frozen accounts. Rosenberg & Given, *Financially Troubled Banks: Private Solutions and Regulatory Alternatives*, 104 *BANKING L.J.* 284, 295 n.31 (1987).

The FDIC in recent years has preferred to use purchase and assumption transactions when banks become insolvent. Norcross, *The Bank Insolvency Game: FDIC Superpowers, The D'Oench Doctrine, and Federal Common Law*, 103 *BANKING L.J.* 316, 319 (1986). The FDIC, as receiver in such a transaction,

solicits bids from other banks for the purchase of some or all of the assets of a failed bank and the assumption of some or all of its liabilities. To the extent the assumed liabilities exceed the purchased assets, the FDIC supplies the cash necessary to enable the assuming bank to "cover" the assumed liabilities.

Rosenberg & Given, *supra*, at 295-96 (footnote omitted). The purchase and assumption transaction avoids many of the disadvantages of deposit payoffs. The FDIC must analyze the costs of a deposit payoff and a purchase and assumption transaction and choose the action that will be the least costly to the insurance fund. 12 U.S.C. § 1823(c) (1982). Failed bank statistics include banks receiving financial assistance from the FDIC in purchase and assumption transactions. C. GOLEMBE & D. HOLLAND, *supra*, at 46.

Rather than pay off insured depositors or arrange a purchase and assumption transaction, the FDIC may provide direct assistance to a financially troubled bank before the Comptroller declares the bank insolvent. Unless continued operation of the troubled bank is essential to the community, the FDIC may furnish direct assistance to a bank only when the aid is reasonably necessary to save the cost of liquidating the bank. 12 U.S.C. § 1823(c)(4)(A) (1982). Failed bank statistics do not include banks which continue to operate after receiving FDIC assistance, regardless of the total assistance given by the FDIC. C. GOLEMBE & D. HOLLAND, *supra*, at 46.

ever, indicate an alarming trend. In 1982, forty-two banks failed.<sup>10</sup> The failures increased to 138 in 1986,<sup>11</sup> and 184 in 1987.<sup>12</sup> The trend continues, with 200 banks failing in 1988.<sup>13</sup>

Failure rates for savings and loan associations mirror the pattern of bank failures. From 1934 to 1979, just thirteen savings and loan associations failed and 124 institutions received assistance from the FSLIC.<sup>14</sup> Those figures spiraled upward, with 211 institutions merged or liquidated from 1981 to 1986.<sup>15</sup> In 1987, forty-eight institutions failed or received assistance.<sup>16</sup> Two-hundred-twenty-three savings and loan institutions failed or received FSLIC assistance during 1988.<sup>17</sup>

### A. Causes of Institution Failures

Several factors may contribute to the failure of a bank or savings and loan association. A recent study of financial institution failures showed that "[n]o one weakness caused an institution to fail."<sup>18</sup> Instead, a "combination of weaknesses" brought on failure.<sup>19</sup> This mingling of factors prevents specific identification of the cause for the increased number of financial institution failures. Economists, and some banking agency

10 1986 FDIC ANN. REP. 53.

11 *Id.* at 8. Additionally, the FDIC provided open bank assistance to seven banks. *Id.*

12 1987 FDIC ANN. REP. 13. The FDIC also provided open bank assistance to 19 banks and participated in 133 purchase and assumption transactions. *Id.*

13 FDIC, 1988 BANK CLOSINGS AND ASSISTANCE TRANSACTIONS MEMORANDUM. In addition to the failed banks, the FDIC provided open bank assistance to 21 banks. *Id.*

14 *Federal Savings and Loan Insurance Corporation Recapitalization Act of 1987: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 100th Cong., 1st Sess. 181 (1987) [hereinafter *Recapitalization Hearings*] (statement of Frederick D. Wolf, Director, Accounting and Financial Management Division, General Accounting Office).

When a federally chartered savings and loan association becomes insolvent, the FHLBB may appoint the FSLIC as receiver for the institution. 12 U.S.C. §§ 1464(d)(6)(D), 1729(b) (1982). The FHLBB may also appoint the FSLIC as receiver for a state chartered federally insured savings and loan association. M. SCHROEDER, *supra* note 1, at ¶ 10.02[1].

The FSLIC, as receiver of an institution, may take actions necessary to return the loan association to a sound solvent condition. The FSLIC may merge the insolvent institution with another insured loan association or the FSLIC may take over the insolvent association's assets and operate the institution. The law also authorizes the FSLIC to liquidate the insolvent institution's assets. 12 U.S.C. § 1729(b)(1)(A) (1982). See M. SCHROEDER, *supra* note 1, at ¶ 10.02[3][b]. If the FSLIC liquidates an institution's assets, the insurance fund pays off depositors up to the statutory insurance limit. *Id.*

Statistics indicate that "the financially assisted merger is the FSLIC's front defense against default." McGuirk, *Default Prevention, Financial Analysis and Modeling: The FSLIC Perspective*, 16 FED. HOME LOAN BANK BOARD J., Oct. 1983, at 10. See generally FED. HOME LOAN BANK SYS., A GUIDE TO THE FEDERAL HOME LOAN BANK SYSTEM 49-54 (1987) (discussion of FSLIC's alternatives for handling insolvent institutions).

15 *Recapitalization Hearings*, *supra* note 14, at 182. During that same time period, the number of insolvent savings and loan associations escalated from 16 in 1980 to 445 insolvent institutions by September of 1986. *Id.*

16 1987 FHLBB ANN. REP. 11.

17 Telephone interview with David Barr, Public Information Officer of the FHLBB (Feb. 6, 1989). In 1988, the FSLIC liquidated 26 savings and loan associations, arranged 179 assisted mergers or acquisitions and stabilized (granted financial assistance to) 18 institutions. *Id.*

18 *Examination and Supervision of Depository Institutions: Hearing Before the House Comm. on Banking, Finance and Urban Affairs*, 101st Cong., 1st Sess. (Jan. 13, 1989) [hereinafter *1989 Hearing*] (unpublished statement of Frederick D. Wolf, Director, General Accounting Office, Accounting and Financial Management Division, at 12) (statement on file at Notre Dame Law Review).

19 *Id.*

leaders, point to the economy as the major cause of failures. Institution failures increased at the same time that economic problems developed in agriculture, energy, and real estate. Some interpret that information as evidence that economic conditions caused the increase in financial institution failures.<sup>20</sup>

A recent study by the Office of the Comptroller of the Currency refutes the claim that economic conditions cause many financial institution failures.<sup>21</sup> The study indicates that most banks fail because of capital depletion, usually produced by poor asset quality.<sup>22</sup> When investigating the factors contributing to poor asset quality, the OCC found that adverse economic conditions make it more difficult for a bank to be profitable but those conditions rarely cause a bank to fail. The economy was a significant factor in thirty-five percent of the bank failures, but economic

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20 OFFICE OF THE COMPTROLLER OF THE CURRENCY, *BANK FAILURE: AN EVALUATION OF THE FACTORS CONTRIBUTING TO THE FAILURE OF NATIONAL BANKS*, at Introduction (1988) [hereinafter OCC STUDY]. Federal regulators claim that fraud presents a "minor issue compared with the collapse of oil prices and real estate values in Texas and Oklahoma." Rosenblatt, *GAO Cites Fraud in Failures of S & L's; Official Calls Misconduct Rampant in Troubled Firms Examined by Agency*, Los Angeles Times, Jan. 14, 1989, at 1, col. 5.

General disagreement exists concerning the causes of bank and savings and loan association failures. Federal regulatory agencies do not agree with each other as to the effect of insider misconduct and other conditions. The Justice Department noted that federal banking agencies believe factors other than insider misconduct are the primary cause of failures. The agencies cited factors such as "careless management or poor economic conditions." *Adequacy of Federal Efforts to Combat Fraud, Abuse, and Misconduct in Federally Insured Financial Institutions: Hearing Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations*, 100th Cong., 1st Sess. 941 (1987). [hereinafter *November 1987 Hearing*].

Some federal banking agencies also reveal internal disagreement concerning the effects of criminal misconduct. The FHLBB continues to blame economic conditions, but some employees reject that idea. A FHLBB Field Manager for Investigations expressed the following view:

It is my opinion that Insider Abuse, not economic problems, is the major factor which has eroded the funds of the FSLIC to insolvency. Even now it may be too late to stop the bleeding, but where there is life there is hope. If the FSLIC recapitalization succeeds in saving the agency and industry, I can think of no way of preventing another massive scam of the FSLIC funds without a major focus at every [savings and loan association] to address fraud and Insider Abuse as soon as it is suspected, rather than waiting for an institution's insolvency.

H.R. REP. NO. 1088, 100th Cong., 2d Sess. 46-47 (1988) (footnote omitted).

21 The OCC examined the "relative roles of external economic difficulties and internal management factors in determining a bank's success or failure." OCC STUDY, *supra* note 20, at Introduction. The study found that the actions of a bank's management wield the greatest influence on whether a bank fails.

The OCC's study is based on an analysis of banks that failed, became problems and recovered, or remained healthy during the period 1979 through 1987. The OCC analyzed 171 failed banks to identify characteristics and conditions present when the banks deteriorated. The OCC also evaluated a sample of 51 rehabilitated banks in similar circumstances that experienced significant difficulties from which they recovered. These rehabilitated banks' composite CAMEL ratings moved from a 1 or a 2, to a 4 or a 5, and then returned to a 1 or a 2, during the 1979 through 1987 period. The OCC evaluated these banks to identify characteristics and conditions present when they became problem banks, and again to identify the characteristics and conditions present when they returned to health. Finally, the OCC evaluated a sample of 38 healthy banks that maintained composite CAMEL ratings of 1 or 2 throughout the period. The healthy banks served as a control group against which the OCC compared the groups that experienced problems.

OCC STUDY, *supra* note 20, at 3. CAMEL ratings provide a uniform rating system indicating the overall condition of banks. For an explanation of CAMEL ratings, see *infra* note 103.

22 OCC STUDY, *supra* note 20, at 5.

conditions were the "sole significant cause of failure" in just seven percent of the banks that failed.<sup>23</sup>

The OCC found that internal problems constituted the "common denominator" among failed and problem banks.<sup>24</sup> The actions and capabilities of a bank's management and board of directors appeared as the usual internal problems. Insider abuse was a significant factor in thirty-five percent of the bank failures; fraud had a similar effect on eleven percent of the failed banks.<sup>25</sup> None of the healthy banks studied by the OCC contained significant insider abuse or fraud.<sup>26</sup> The OCC concluded that "strong management and systems can prevent failure and promote recovery even during difficult economic times."<sup>27</sup>

The Government Accounting Office (GAO) recently completed reviews of savings and loan association and bank failures.<sup>28</sup> The Director of the GAO Accounting and Financial Management Division commented on the reviews' findings, noting that "[s]ome within the financial institutions industry have expressed the view that the unprecedented problems and resultant failures are largely due to economic downturns in certain regions. However, both of our reviews lead to a different conclusion."<sup>29</sup> Like the OCC Study, the GAO reviews found that "well-managed institutions with strong internal controls" can continue successful operation even in areas experiencing economic problems.<sup>30</sup>

The GAO uncovered high levels of insider abuse and fraud. Using the FHLBB's definitions,<sup>31</sup> the GAO found that "fraud or insider abuse existed at each and every one of the failed thrifts."<sup>32</sup> The control group

23 *Id.* at 10. Interestingly, economic conditions significantly contributed to the problems of more banks that eventually recovered than banks that failed. Sixteen percent of the rehabilitated banks recovered while operating in "significantly depressed" economies while an additional 67% recovered in areas experiencing "marginally depressed" economies. *Id.*

24 *Id.* at Introduction.

25 *Id.* at 9. The study identified insider abuse as "self-dealing, undue dependence on the bank for income or services by a board member or shareholder, inappropriate transactions with affiliates, or unauthorized transactions by management officials." *Id.*

26 *Id.* at 13.

27 *Id.* at 12.

28 1989 *Hearing*, *supra* note 18. The GAO

analyzed examination reports and other related supervisory documentation for failed thrifts and banks to determine whether such institutions are characterized by conditions or operating practices that distinguish them from healthy institutions. In addition, [the GAO] interviewed numerous regulatory and industry officials, attorneys, and others knowledgeable about the thrifts and banks. [The GAO] also examined the role which insider abuse and fraud as well as environmental factors, primarily economic conditions, played in these failures.

*Id.* at 10. The GAO expects to release its report on the reviews in the spring of 1989.

The GAO review of savings and loan associations covered 26 institutions "which FSLIC either began assisting between January 1, 1985, and September 30, 1987, or anticipated assisting as of September 30, 1987." *Id.* The GAO staff compared that sample group of institutions to a control group of "similar, but solvent" savings and loan associations. *Id.*

29 *Id.* at 11.

30 *Id.*

31 The FHLBB defines insider abuse and fraud to include "breaches of fiduciary duty, self-dealing, engaging in high-risk speculative ventures, excessive expenditures and compensation, and conflicts of interest, among other activities." *Id.* at 21.

32 *Id.* at 13. The GAO found allegations of criminal misconduct in 19 of the 26 savings and loan associations. Mr. Wolf's testimony indicated that there may have been additional criminal allegations to which the GAO had no access. *Id.*

of healthy savings and loan associations possessed "significantly fewer internal control weaknesses than failed institutions."<sup>33</sup> The healthy institutions complied with laws and regulations.<sup>34</sup>

Failed banks in the GAO review also contained insider abuse and fraud. Sixty-four percent of the failed banks studied by the GAO revealed insider abuse.<sup>35</sup> Insider fraud was present in thirty-eight percent of the failed banks.<sup>36</sup> The GAO listed a lack of significant insider abuse or fraud as a characteristic distinguishing healthy savings and loan associations and banks from institutions that failed.<sup>37</sup>

A congressional study also linked insider abuse and criminal misconduct to financial institution failures.<sup>38</sup> That study concluded that approximately fifty percent of all bank failures "are caused, in large part, by the criminal misconduct of officers, directors and insiders."<sup>39</sup> Insider criminal misconduct, according to the congressional study, causes approximately twenty-five percent of savings and loan association failures.<sup>40</sup> Those figures, although high, do not include insider abuse that fell short of criminal misconduct.

Failures connected directly or indirectly to insider abuse or criminal misconduct are not a new occurrence. The percentage of such failures, however, is increasing. An FDIC study of bank failures from 1960 to 1974 found approximately thirty percent of the failures caused by criminal misconduct, "defalcation, embezzlement, and manipulation."<sup>41</sup> The FDIC statistics for bank failures from 1980 to 1983 reveal criminal misconduct as a "major contributing factor" in forty-five percent of the failures.<sup>42</sup> An even stronger link exists between insider activities and financial institution failures when instances of insider abuse are added to the criminal misconduct figures.

Although it is clear that insider abuse and criminal misconduct play a significant role in institution failures, exact causation statistics are difficult to determine. Insider misconduct may directly cause an institution

<sup>33</sup> *Id.* at 28.

<sup>34</sup> *Id.* at 13.

<sup>35</sup> *Id.* at 21. The GAO staff reviewed the 184 FDIC insured banks that closed in 1987. *Id.* at 10.

<sup>36</sup> *Id.* at 21.

<sup>37</sup> *Id.* at 29.

<sup>38</sup> In an effort to determine the impact of insider activities on institution failures, the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Committee on Government Operations (the subcommittee) studied bank and loan association failures between 1980 and 1983. The subcommittee analyzed the 75 banks insured by the FDIC that failed between January 1, 1980 and June 17, 1983. It also analyzed the 30 savings and loan associations that the FHLBB placed in involuntary receivership between January 1980 and July 1983. HOUSE COMM. ON GOVERNMENT OPERATIONS, FEDERAL RESPONSE TO CRIMINAL MISCONDUCT AND INSIDER ABUSE IN THE NATION'S FINANCIAL INSTITUTIONS, H.R. REP. NO. 1137, 98th Cong., 2d Sess. 29-30 (1984) [hereinafter 1984 REPORT].

<sup>39</sup> *Id.* at 30. The subcommittee based that conclusion on its own finding that 61% of the failures involved insider criminal misconduct and the FDIC's estimate that criminal misconduct served as a major contributing factor in 45% of the failures. *Id.* at 29-30.

<sup>40</sup> The subcommittee approved the 25% figure after it had identified criminal misconduct as a major cause in 36% of the loan association failures for 1980-83, while the FHLBB estimated the number at 23%. *Id.*

<sup>41</sup> *Id.* at 29. That FDIC study indicated that an additional 53.8% of the failures were caused by insider abuse: "self-serving loans to bank management or friends of management." *Id.*

<sup>42</sup> *Id.* at 30.



to fail, but often the misconduct alone would not bring about failure. Capital depletion caused by insider misconduct generally combines with other factors, such as economic problems, to lead to insolvency.<sup>43</sup> Economic problems may help to reveal insider abuse or criminal misconduct.

Although some financial frauds clearly would collapse and become exposed under their own weight due to the lack of sophistication of those who perpetuated the frauds or because of the inherent weaknesses built into the schemes themselves, many other frauds would yet remain unexposed but for an economic crisis which accelerated, facilitated, and precipitated their detection.<sup>44</sup>

In the words of bank investigators, "[f]rauds are easy to hide when profits are good."<sup>45</sup>

### B. *Costs of Institution Failures*

Regardless of the specific contribution of misconduct to each failure, insider abuse or criminal misconduct plays a role in a significant number of financial institution failures. Those insider activities carry huge costs.

Estimates of the dollar costs vary. Investigators calculate bank fraud losses for the 1970's at less than \$1.5 billion.<sup>46</sup> After congressional inquiries, the FDIC and FSLIC estimated that the insurance funds lost more than \$1 billion from institution failures between 1980 and 1983 where criminal misconduct was a major contributing factor.<sup>47</sup>

The most recent statistics reveal loss figures that continue to grow. The FDIC lost \$676 million from 1985 through the first half of 1987 due to bank failures where insider misconduct was a significant contributing factor.<sup>48</sup> The FSLIC will lose at least \$12 billion from institutions that failed or became insolvent between 1984 and mid-1987 where misconduct contributed to the insolvency.<sup>49</sup>

The dollar amounts alone are staggering, but the costs of insider abuse and criminal misconduct extend beyond those figures. Economists view the safety and soundness of the banking system as a necessary component of a stable economy.<sup>50</sup> Thus, excessive failures affect the

43 1989 Hearing, *supra* note 18, at 13.

44 November 1987 Hearing, *supra* note 20, at 27 (statement of Henry Oncken, U.S. Attorney, Southern District of Texas).

45 McCoy, *Financial Fraud: Theories Behind Nationwide Surge in Bank Swindles*, Wall. St. J., Oct. 2, 1987, at 15, col. 4.

46 *Id.* The FBI adds loss figures when an investigation closes. Because investigations may continue through several years, the FBI's figures for the 1970's are not yet complete and involve some estimation. *Id.*

47 1984 REPORT, *supra* note 38, at 28. That figure indicates total losses from the failures connected to criminal misconduct, not just the losses "attributable solely to criminal misconduct." *Id.*

48 November 1987 Hearing, *supra* note 20, at 638.

49 HOUSE COMM. ON GOVERNMENT OPERATIONS, COMBATING FRAUD, ABUSE, AND MISCONDUCT IN THE NATION'S FINANCIAL INSTITUTIONS: CURRENT FEDERAL EFFORTS ARE INADEQUATE, H.R. REP. NO. 1088, 100th Cong., 2d Sess. 10-11 (1988) [hereinafter 1988 REPORT]. The FSLIC did not willingly release those huge loss figures. After the first loss figures provided by the FHLBB were suspiciously low, the subcommittee investigated and found the reported figures. The FHLBB's reluctance to reveal the actual loss figures was attributed to a feeling that such disclosure "could not help the industry and could possibly be 'inflammatory.'" *Id.* at 55.

50 A sound banking system protects individual depositors, prevents bank failures and avoids disruptions in the money supply. J. NORTON & S. WHITLEY, BANKING LAW MANUAL § 2.06 (1987).

strength of the banking system and the economy. Widespread financial institution failures in the past resulted in national recessions and contractions of the money supply.<sup>51</sup> Although the tangible effects of the current situation may not have reached those proportions yet, failures caused by insider abuse and criminal misconduct weaken public confidence in the banking system and ultimately weaken the economy.<sup>52</sup> Regulators still fear the possible consequences of widespread failures.

## II. Enforcement Actions

Maintaining the safety and soundness of the financial system requires taking action against those responsible for insider abuse and criminal misconduct. The current legal and administrative framework provides for sanctions against the perpetrators of insider misconduct. Regulatory agencies may pursue civil enforcement actions against financial institutions and individuals. The agencies may initiate civil litigation against individuals in an effort to recover damages for losses incurred by failed financial institutions. Individuals may also face criminal charges for misconduct.

### A. Civil Actions

In the past, banking agencies used informal actions to correct misconduct and unsafe or unsound practices.<sup>53</sup> When informal action ceased to be effective, Congress expanded the disciplinary powers of the banking agencies.<sup>54</sup> Currently, the agencies possess the authority to pursue the following civil enforcement actions: formal agreements,<sup>55</sup> cease

51 N. LASH, *supra* note 1, at 23.

52 *November 1987 Hearing*, *supra* note 20, at 530 (statement of William F. Weld, Assistant Attorney General, Criminal Division).

53 "Moral suasion, 'jawboning,' and, if necessary, pressure were used to solve problems without having to resort to formal enforcement actions." 1984 REPORT, *supra* note 38, at 143. Regulators resolved problems with persuasive discussions or letters, practices that have been called "regulation by raised eyebrow." Hawke, *Assuring Safety and Soundness: The Role of the Enforcement Process*, 5 ANN. REV. BANKING L. 167 (1986).

54 The Financial Institutions Supervisory Act of 1966 (FISA) authorized the federal banking agencies to take the following actions: issue cease and desist orders, require completion of certain actions, issue prohibition orders and remove officers or directors. Financial Institutions Supervisory Act of 1966, Pub. L. No. 89-695, 80 Stat. 1028. See Huber, *Enforcement Powers of Federal Banking Agencies*, 7 ANN. REV. BANKING L. 123, 133-40 (1988).

Regulatory enforcement authority expanded again with passage of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA). Financial Institutions Regulatory and Interest Rate Control Act of 1987, Pub. L. No. 95-630, 95 Stat. 3641. Banking agencies gained the power to issue cease and desist orders against officers, directors, and insiders. (FISA allowed such orders only against institutions.) FIRA also granted authority to issue civil money penalties and broadened the agencies' power to remove or suspend officers and directors. See Huber, *supra*, at 140-47.

55 Formal agreements, or memoranda of understanding, represent the mildest type of formal action. The person involved in the misconduct voluntarily enters into a written agreement with the banking agency. 1984 REPORT, *supra* note 38, at 145. The agency generally cannot enforce an agreement in court, but violations of a written agreement provide grounds for a cease and desist order. A. POLLARD, J. PASSAIC, JR., K. ELLIS, & J. DALY, *BANKING LAW IN THE UNITED STATES* § 5.8 (1988) [hereinafter A. POLLARD]. "Agreements with individuals . . . are relatively quick and painless ways for the agencies to address problems of insider abuse without stigmatizing the entire institution or going through the agencies' cumbersome procedures to issue a cease and desist order or impose civil money penalties." 1984 REPORT, *supra* note 38, at 145.

and desist orders,<sup>56</sup> civil money penalties,<sup>57</sup> suspensions, and removals.<sup>58</sup>

The banking agencies as a group have not consistently or vigorously used the civil enforcement actions available to them. In 1984, the subcommittee concluded that "[t]he banking agencies often fail to take direct civil enforcement action against individuals engaged in insider abuse, notwithstanding a clear statutory responsibility to do so."<sup>59</sup> Linking the enforcement action statistics to the congressional study of failed institutions, the subcommittee found that "where the likelihood of criminal misconduct by insiders was high or where the agencies themselves had made criminal referrals involving insiders, the agencies took direct enforcement action against individuals in only thirty percent of the cases."<sup>60</sup>

<sup>56</sup> Cease and desist orders provide a more powerful enforcement measure than formal agreements. The orders can mandate termination of practices and require affirmative steps to correct problems. Huber, *supra* note 54, at 133. Cease and desist orders are legally enforceable; the charged party possesses the right to an administrative hearing. A. POLLARD, *supra* note 55, at § 5.2. Banking agencies may issue cease and desist orders when an institution or individual engages in an unsafe or unsound practice or violates a law, rule, regulation or written agreement. See 12 U.S.C. §§ 1464(d)(2), 1730(e), 1818(b) (1982).

Banking agencies may issue temporary cease and desist orders in certain emergency situations. Temporary orders are appropriate when the practices in question "are likely to cause insolvency or substantial dissipation of assets or earnings of the institution or generally to weaken the condition of the institution or otherwise seriously prejudice the interests of depositors." A. POLLARD, *supra* note 55, at § 5.2. See 12 U.S.C. §§ 1464(d)(3), 1730(f), 1818(c) (1982).

<sup>57</sup> Federal banking agencies received the power to issue civil money penalties under FIRA in 1978. See 12 U.S.C. §§ 1464(d)(8)(B), 1730(k)(3), 1818(i)(2) (1982 & Supp. IV 1986). Congress characterized civil money penalties as intermediate actions, more severe than informal actions or written agreements, but less drastic than cease and desist orders. 1984 REPORT, *supra* note 38, at 146.

Banking agencies may assess civil money penalties against financial institutions and institution directors, officers, employees and agents. See 12 U.S.C. §§ 1464(d)(8)(B), 1730(k)(3), 1818(i)(2) (1982 & Supp. IV 1986). Violating certain statutes or cease and desist orders subjects an institution or individual to possible penalties. A. POLLARD, *supra* note 55, at § 5.4. Each banking agency possesses different authority to assess civil money penalties for statutory violations. See 1984 REPORT, *supra* note 38, at 147-48; A. POLLARD, *supra* note 55, at § 5.4.

<sup>58</sup> Regulatory agencies may suspend or remove directors, officers, employees or individuals involved in a financial institution's affairs. See 12 U.S.C. §§ 1464(d)(4), 1730(g),(h), 1818(e),(g) (1982). The following actions may result in suspension or removal: violating a law, rule, regulation, or cease and desist order; engaging in unsafe or unsound practices or breaching a fiduciary duty; engaging in actions that have caused or will cause substantial loss to the institution; acting with personal dishonesty; demonstrating willful or continuing disregard for the institution's safety and soundness. See *id.* The subcommittee noted that the statutory requirements for suspension and removal "reach only the most egregious cases of abusive conduct." 1984 REPORT, *supra* note 38, at 149.

<sup>59</sup> 1984 REPORT, *supra* note 38, at 152. The subcommittee analyzed civil enforcement actions taken against institutions and individuals from 1980 to 1983. The statistics show actions taken by the Federal Reserve, OCC, FDIC and FHLBB. The figures include the following actions: formal agreements; cease and desist orders; civil money penalties; and removals, suspensions and prohibitions.

In 1980, all four banking agencies pursued a total of just 23 actions against individuals. *Id.* at 154-55. That figure increased to 34 in 1981, 158 the next year and 224 in 1984. *Id.* An increase in civil money penalties issued by the OCC and FDIC accounted for the greater number of actions against individuals. *Id.* at 153.

The OCC most vigorously pursued civil enforcement actions against individuals, taking 270 actions during the four year period of 1980 to 1983. *Id.* at 156. The FDIC pursued 114 actions during that time, while the FHLBB instituted 44 actions. The Federal Reserve took action against individuals only 11 times in four years. *Id.*

<sup>60</sup> *Id.* at 156 (footnote omitted).

Federal banking agencies' civil enforcement actions since 1984 have improved in some respects and deteriorated in others. In 1984, the subcommittee recommended increased use of civil enforcement actions against individuals involved in insider abuse.<sup>61</sup> The agencies' adherence to that recommendation varies. The OCC has been the most diligent of the agencies in this area;<sup>62</sup> the FDIC holds the poorest record.<sup>63</sup>

In the 1988 Report, the subcommittee noted the "mixed" record of recent years.<sup>64</sup> The subcommittee recommended that the FDIC and the Federal Reserve "substantially increase their use of civil enforcement actions against officers, directors, employees, or other insiders engaged in unsafe and unsound practices, abusive actions, serious violations of regulations, and other misconduct."<sup>65</sup>

Although some agencies have increased enforcement actions against individuals, all banking agencies have reduced the number of civil enforcement actions taken against institutions since 1984.<sup>66</sup> The subcommittee in its 1988 Report recommended that all four federal agencies (OCC, Federal Reserve, FDIC and FHLBB) "substantially increase" utilization of civil enforcement actions against institutions.<sup>67</sup>

Several factors contribute to the continuing problems associated with civil enforcement actions against individuals and institutions. Key policy disputes have led to the inconsistent use of certain types of civil

61 *Id.* at 22-23.

62 The OCC brought 779 civil enforcement actions against individuals during the four year period of 1984 to 1987. 1988 REPORT, *supra* note 49, at 75.

63 During the four years from 1984 to 1987, the FDIC pursued only 444 enforcement actions against individuals. *Id.* The agency's actions jumped from 75 in 1984 to 260 in 1985, but then declined to 49 in 1986 and 32 in 1987. *Id.*

The FDIC took action less than 450 times although it supervised 8,240 state nonmember banks. In contrast, the OCC supervised approximately 4,900 national banks and pursued over 775 enforcement actions during the same time period. *Id.* at 76. The few FDIC enforcement actions do not correspond to a lower level of misconduct. From 1985 through mid-1987, "almost two-thirds of all failed banks where misconduct, insider abuse, or fraud was present were state nonmember banks." *Id.*

64 The OCC supervised approximately 4,900 national banks and pursued 779 enforcement actions against individuals from 1984 to 1987. The OCC brought 129 actions in 1984, 225 actions in 1985, 235 in 1986, and 190 in 1987. *Id.* at 75-76.

The Federal Reserve Board supervised 1,100 state member banks. The Board pursued 18 enforcement actions in 1984 against individuals associated with those banks. Federal Reserve Board enforcement actions increased to 35 in 1985, but fell to 9 in 1986 and 8 in 1987. *Id.*

The FHLBB supervised 3,250 institutions and increased its enforcement actions each year. In 1984, the FHLBB brought 27 actions. That number increased to 49 in 1985, 57 in 1986, and 59 in 1987. *Id.* Although the raw figures seem small, the FHLBB possesses a more limited authority to issue civil money penalties. The FHLBB used the removal and suspension powers "almost as frequently as the OCC and more frequently than the other agencies." *Id.* at 76.

For FDIC enforcement action statistics, see *supra* note 63.

65 1988 REPORT, *supra* note 49, at 25.

66 The OCC brought 391 civil enforcement actions against institutions in 1984, 426 the next year and 371 in 1986. The OCC pursued only 141 actions against institutions in 1987. *Id.* at 76.

Similarly, the Federal Reserve Board took 175 enforcement actions against institutions in 1984, 255 actions in 1985 and 278 in 1986, but only 121 in 1987. *Id.*

The FHLBB followed the pattern. It pursued 129 civil enforcement actions against institutions in 1984, 247 in 1985, 261 in 1986, followed by just 132 in 1987. *Id.*

Civil enforcement actions by the FDIC against institutions numbered 501 in 1984 and 599 in 1985. The actions decreased to 563 in 1986 and 480 in 1987. *Id.*

67 *Id.* at 25.

enforcement actions.<sup>68</sup> Collection of civil money penalties varies greatly among the banking agencies.<sup>69</sup> The subcommittee also found that the heads of the federal banking agencies, particularly the FDIC and OCC, have failed to demonstrate a firm commitment to civil enforcement actions.<sup>70</sup>

In addition to civil enforcement actions, the FDIC and FSLIC may pursue civil litigation against directors, officers and other individuals after a financial institution fails.<sup>71</sup> Those suits are classified as "recovery actions" or "collection efforts" rather than enforcement procedures.<sup>72</sup>

68 Once a financial institution has failed, the FDIC and FHLBB prefer to bring civil suits seeking damages from individual officers and directors. Those agencies, as receivers, try to recover the maximum amount possible for the institution. Damages from civil suits add to the institution's assets and reduce the potential insurance claims that must be paid by the FDIC and FSLIC. 1984 REPORT, *supra* note 38, at 157. In the words of former FDIC Chairman Isaac, our strongest enforcement action against individuals who cause serious problems in banks would be in the area of failed bank activity. Whenever a bank fails, you can bet your house that we are going to be suing the officers and directors, the accounting firm, and others that were involved in that bank.

*Federal Response to Criminal Misconduct By Bank Officers, Directors, and Insiders (Part 2): Hearing Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations*, 98th Cong., 2d Sess. 532-33 (1984), *quoted in* 1984 REPORT, *supra* note 38, at 158.

Civil money penalties, however, are paid into the United States Treasury. 1984 REPORT, *supra* note 38, at 157. The OCC advocates assessing civil money penalties against individuals, even after a financial institution has failed. C. Todd Conover, Comptroller of the Currency, noted the awkwardness of the opposing views of the FDIC and the OCC. *Id.* at 158.

69 Actual collection rates of assessed civil money penalties vary a great deal. The FDIC seems to experience particular difficulties in collecting. For penalties assessed from 1984 to 1986, the FDIC had 79.1% uncollected when open institutions were involved and 97.9% uncollected for failed institutions. *Id.* at 84.

During the same time period, the OCC collected all but 27% of the civil money penalties. *Id.* The Federal Reserve Board has a single \$50,000 penalty outstanding. *Id.*

70 FDIC personnel told the subcommittee's staff "why the FDIC less frequently pursues vigorous civil enforcement action." 1988 REPORT, *supra* note 49, at 82. Individuals noted that [d]uring a series of meetings with FDIC staff at headquarters and in regional offices after he became FDIC Chairman, Mr. Seidman indicated a change in tone and direction. Rather than the "confrontational" approach of former FDIC Chairman Isaac, Mr. Seidman articulated a more congenial and accommodating FDIC approach to the industry. Reforming and helping the industry became the FDIC's primary goal; efforts against insider abuse were not to be ignored, but they would not have the priority that they once did. During these meetings with FDIC staff, just after Mr. Seidman took over the chairmanship of the FDIC in 1985, he routinely made the following statements: "bankers are our friends"; "the FDIC should be a friend of the industry"; and it should be like a "trade association" for the industry. To FDIC staff, the message was clear: "Go easy on this industry."

*Id.* at 82-83. Chairman Seidman's policies have had a "chilling effect" on civil enforcement actions. *Id.* at 83.

Similar problems exist at the OCC. Comptroller of the Currency Clarke has displayed less than enthusiastic support for civil enforcement actions. *See id.* at 83-84.

71 The status of the FDIC and FSLIC as regulators and insurers of financial institutions allows the agencies to bring the civil suits.

As insurers of financial institutions, the FDIC and FSLIC regularly become assignees or subrogees of claims of failed institutions in connection with payment of assistance to a third-party acquirer of the institution. In addition, as receivers or conservators of insolvent institutions, they are in a position to pursue causes of action that belong to the institution. Vartanian & Schley, *Bank Officer and Director Liability — Regulatory Actions*, 39 BUS. LAW. 1021, 1028 (1984).

Banks continuing to operate may bring civil litigation suits in their own right against individuals involved in abusive practices.

72 Stewart, *Enforcement Actions Against Officers and Directors: The Regulator's Approach (Supervisor Enforcement Tools: C & D Actions, Civil Litigation)*, 51 LEGAL BULL. 67, 68 (1985). Banking agencies use civil suits primarily to seek recovery of the money lost by the agency during an assistance transaction

Agency suits against individuals often assert claims of common law fraud, negligence, breach of fiduciary duty, and violations of banking statutes and civil RICO.<sup>73</sup> Financial Institution Bonds (Bankers Blanket Bonds)<sup>74</sup> or directors and officers liability insurance policies generally cover the claims against individuals.<sup>75</sup> The FDIC and FSLIC are also bringing an increasing number of civil suits against accountants, attorneys and other professionals associated with failed financial institutions.<sup>76</sup>

### B. Criminal Actions

Banking agencies possess no authority to prosecute individuals on criminal charges; agency personnel must refer suspected criminal conduct in financial institutions to the United States Department of Justice.<sup>77</sup>

or liquidation of a financial institution. The suits may also have some deterrent effect on insiders at other financial institutions. *Id.*

73 See, e.g., *FDIC v. Antonio*, 843 F.2d 1311 (10th Cir. 1988); *FSLIC v. Shearson-American Express, Inc.*, 658 F. Supp. 1331 (D. Puerto Rico 1987); *FDIC v. Hardin*, 608 F. Supp. 348 (E.D. Tenn. 1985) (civil RICO suits). See generally Galbraith & Seidel, *FDIC Vs. Imprudent Banking Officials: The Enforcement Apparatus*, 104 BANKING L.J. 92, 120-26 (1987); Note, *When Change Meets Tradition: The Paradox of Thrift Director Liability*, 6 ANN. REV. BANKING L. 413, 439-40 (1987) (general discussions of banking agency civil suits against individuals); U.S. DEPARTMENT OF JUSTICE, *CIVIL RICO: A MANUAL FOR FEDERAL PROSECUTORS* (1988); Blakey & Gettings, *Racketeer Influenced and Corrupt Organizations (RICO): Basic Concepts — Criminal and Civil Remedies*, 53 TEMP. L.Q. 1009 (1980) (general discussions of civil RICO suits).

FDIC and FSLIC often settle claims against directors and officers before going to trial. The agencies frequently negotiate settlements with the insurer providing the directors and officers liability insurance policies in effect when the financial institution failed. Skillern, *Federal Deposit Insurance Corporation and the Failed Bank: The Past Decade (Part II)*, 99 BANKING L.J. 292, 310 (1982). For directors and officers liability insurance coverage of civil RICO claims, see Ichel & Thompson, *Directors' and Officers' Insurance Coverage: An Overview and Current Issues*, in PRACTISING LAW INSTITUTE, *SECURITIES LITIGATION* 257, 319-35 (1987).

74 Financial Institution Bonds or Bankers Blanket Bonds provide fidelity insurance coverage to financial institutions for "loss resulting directly from dishonest or fraudulent acts of an employee committed alone or in collusion with others." Ichel & Thompson, *supra* note 73, at 340. That protection includes losses from "embezzlement, larceny, breach of duty, personal dishonesty, wrongful extraction and willful misapplication." J. NORTON & S. WHITLEY, *supra* note 50, § 6.03[2]. To recover from the bond provider, the financial institution (or the agency bringing the claim) must prove that the loss was due to the dishonesty of an insured employee. *Id.* See generally Neel, *Financial Institution and Fidelity Coverage for Loan Losses*, 21 TORT & INS. L.J. 590, 605-10 (1986); Skillern, *supra* note 73, at 307-10.

The provisions of Bankers Blanket Bonds generally state that an insurer who pays on the loss is subrogated to the claims that the insured institution possesses against third parties. Bond insurers may file subrogation claims against bank directors, alleging that the directors failed to adequately supervise the employee whose dishonest conduct resulted in the loss. Those claims against financial institution directors may trigger directors and officers liability insurance coverage for the directors involved. Ichel & Thompson, *supra* note 73, at 341.

75 Directors and officers liability insurance policies cover "defense costs and liabilities incurred by insured directors and officers arising out of claims alleging that an insured executive has committed 'wrongful acts.'" Ichel & Thompson, *supra* note 73, at 259. Each policy defines the included "wrongful acts." Policies generally cover only conduct by an insured director or officer acting in his or her capacity as a director or officer. *Id.* at 269. Certain notice requirements and exclusions apply to insurance coverage. See generally *id.* at 257-344 (overview of directors and officers insurance coverage).

76 The FSLIC greatly increased civil suits against law firms, accounting firms and appraisal firms involved with the many savings and loan institutions that failed in Texas. Kahler, *Justice Assembles Team to Probe Texas Thrifts*, *Legal Times*, Aug. 10, 1987, at 8, col. 1. The deputy general counsel of the FSLIC noted that "when there is a failure and money is lost, we have a fiduciary duty to recover as much money as possible, so we are looking at everyone who is responsible for the loss. The cases coming up now are for malpractice and we will go after it where it occurs." *Id.*

77 See *infra* notes 108 to 111 and accompanying text.

The Justice Department, with investigatory help from the FBI, prosecutes such cases.

Federal prosecutors may bring a variety of criminal charges against insiders suspected of misconduct in financial institutions. Certain federal statutes specifically refer to offenses against financial institutions: bank bribery,<sup>78</sup> misapplication of bank funds,<sup>79</sup> false entries in bank records,<sup>80</sup> and receipt of stolen bank property.<sup>81</sup> In the past, those statutes did not adequately address the misconduct occurring in financial institutions.<sup>82</sup> The subcommittee, in its 1984 Report, termed the criminal statutes in this area "archaic."<sup>83</sup> Congress responded to the need for statutory improvement by enacting the bank related provisions of the Comprehensive Crime Control Act of 1984.<sup>84</sup>

That Act included a new statute concerning fraud against federally chartered or insured financial institutions.<sup>85</sup> The fraud statute prohibits

78 18 U.S.C. § 215 (Supp. IV 1986). The bank bribery provisions prohibit giving, offering or promising anything of value to any person with intent to influence or reward an officer, director, employee, agent or attorney of a financial institution. 18 U.S.C. § 215(a)(1) (Supp. IV 1986). The statute also applies to specified insiders who solicit, accept, or agree to accept anything of value with an intent to be influenced or rewarded in connection with a transaction. 18 U.S.C. § 215(a)(2) (Supp. IV 1986). The bank bribery provisions apply to FDIC insured banks and FSLIC insured savings and loan associations. 18 U.S.C. § 215(b) (Supp. IV 1986).

79 18 U.S.C. § 656 (1982). The statute prohibits an officer, director, agent, employee of, or individual connected in any capacity with, a federally insured bank from embezzling, purloining or willfully misapplying the bank's funds. *Id.* To prove that a defendant violated that section, the prosecutor must show

- 1) that the accused was an officer, director, or employee of the bank; 2) that the bank was in some way connected with a nationally or federally insured bank; 3) that the accused willfully misapplied the funds of the bank; and 4) that the accused acted with the intent to injure or defraud the bank.

Jorgensen, *White-Collar Crime: Fourth Survey of Law, Embezzlement*, 24 AM. CRIM. L. REV. 513, 518 (1987). Section 657 of title 18 covers the same conduct in federally insured credit institutions, including savings and loan associations. 18 U.S.C. § 657 (1982).

80 18 U.S.C. §§ 1005, 1006 (1982). Section 1005 prohibits a person from making false entries in bank books, reports, or statements with an intent to injure or defraud the bank or to deceive a bank officer or examiner. *See* 18 U.S.C. § 1005 (1982). Section 1006 applies to false entries in the books, reports or statements of savings and loan associations. *See* 18 U.S.C. § 1006 (1982). The intent requirement differs between the two sections. *See infra* note 82.

81 18 U.S.C. § 2113(c) (1982 & Supp. IV 1986). This section prohibits a person who knows property has been stolen from receiving, possessing, concealing, selling or disposing of property stolen from a bank or loan association. *See infra* note 90 (discussion of 1984 amendment).

82 The bank bribery statute addressed the receipt of something of value by a bank officer, director or insider in order to procure a loan, but the provision did not apply to the payment of bribes or kickbacks. *See* 1984 REPORT, *supra* note 38, at 121. For amendments to the bank bribery statute, see *infra* notes 88-89 and accompanying text.

The misapplication of bank funds statute engenders interpretation problems. Juries struggle to understand instructions defining "misapply" and federal judges interpret the term differently among federal circuits. *Id.* at 119.

The provisions covering false entries in bank records, 18 U.S.C. §§ 1005, 1006 (1982), differ in the state-of-mind required of the defendant. When prosecuting for false entries in bank records, the government must show an "intent to injure or to defraud." 18 U.S.C. § 1005 (1982). Section 1006 applies to savings and loan association records, but that section requires that the defendant possessed an "intent to deceive." 18 U.S.C. § 1006 (1982). The subcommittee noted that no reason supports the government's differing burdens. 1984 REPORT, *supra* note 38, at 122.

83 1984 REPORT, *supra* note 38, at 118. The Department of Justice and the federal banking agencies found those criminal statutes inadequate. *Id.* The subcommittee concluded that "[t]he criminal statutes relating to insider loans, bank bribery, and bank fraud are archaic and do not satisfactorily address the types of 20th Century schemes uncovered in modern bank fraud investigations." *Id.*

84 Comprehensive Crime Control Act of 1984, Pub. L. No. 98-473, 98 Stat. 1837.

85 18 U.S.C. § 1344 (Supp. IV 1986).

schemes to defraud those institutions and schemes to obtain money or property owned or controlled by such institutions.<sup>86</sup> Prosecutors received additional authority for actions to stop fraudulent schemes while an investigation continues.<sup>87</sup>

The 1984 Act also amended various banking provisions. The Act modified the bank bribery statute, expanding the list of potential defendants to include the person who offers or pays the bribe as well as the person who receives the bribe.<sup>88</sup> The revised bank bribery provision "deals with all facets of bank bribery and provides for felony as well as misdemeanor prosecution, depending upon the amount involved."<sup>89</sup> Provisions concerning receipt of stolen bank property were also amended.<sup>90</sup>

In addition to banking statutes, prosecutors may use general federal statutes in cases involving criminal misconduct in financial institutions. Prosecutors continue to use federal statutes for mail fraud,<sup>91</sup> wire

86 18 U.S.C. § 1344(a) (Supp. IV 1986).

87 18 U.S.C. § 1345 (Supp. IV 1986). Section 1345 authorizes prosecutors to bring a civil action in federal court seeking an injunction against a person engaged or about to engage in a fraudulent act. *Id.*

88 18 U.S.C. § 215 (Supp. IV 1986). Prior to the amendment, the bank bribery provisions only applied to the recipient of the bribe.

89 diGenova & Belfiore, *An Overview of the Comprehensive Crime Control Act of 1984 — The Prosecutor's Perspective*, 22 AM. CRIM. L. REV. 707, 731 (1985).

The 1984 bank bribery statute amendment created confusion over the conduct prohibited by the provision. Commentators posed a hypothetical scenario:

[I]t would be a felony for a corporation to host a weekend at an expensive resort or hunting lodge to discuss specific or general future financing plans, and to invite the banker, the lawyer, the investment banker, the CPA, etc. To avoid prosecution, the banker would have to pay his own way.

Dennis & Chafetz, *The New Bank Bribery Act: A Trap For the Unwary*, 102 BANKING L. J. 316, §18 (1985).

Congress amended the bank bribery statute again in 1986. Act of Aug. 4, 1986, Pub. L. No. 99-370, 100 Stat. 779. Those modifications attempted to reduce confusion and required the federal regulatory agencies to establish guidelines for complying with the provisions. See 18 U.S.C. § 215(d) (Supp. IV 1986).

90 See 18 U.S.C. § 2113(c) (Supp. IV 1986). To be convicted of receiving stolen bank property, a defendant must now merely know that the property was stolen. Prior cases required that the defendant knew property was stolen from a financial institution. diGenova & Belfiore, *supra* note 89, at 731.

91 18 U.S.C. § 1341 (1982). Section 1341 provides in relevant part:

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, . . . for the purpose of executing such scheme or artifice . . . places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail . . . any such matter or thing, shall be fined not more than \$1,000 or imprisoned not more than five years, or both.

*Id.* Federal prosecutors first used the mail fraud provision to prosecute misconduct in financial institutions that was not otherwise covered by federal criminal statutes relating to financial institutions.

Section 1341 of Title 18 U.S.C. has traditionally been used against fraudulent activity as a first line of defense. When a "new" fraud develops—as constantly happens—the mail fraud statute becomes a stopgap device to deal on a temporary basis with the new phenomenon, until particularized legislation can be developed and passed to deal directly with the evil.

United State v. Maze, 414 U.S. 395, 405-06 (1974), *quoted in* Best, *Bank Fraud Statute Reaches Broad Variety of Conduct*, INSIDE LITIGATION, June 1987, at 24.

Although "particularized" provisions now apply to financial institution fraud, prosecutors continue to use mail fraud charges, often in addition to charges under banking related statutes. The Racketeer Influenced and Corrupt Organizations statute (RICO) defines mail fraud as a "racketeer-



fraud,<sup>92</sup> conspiracy,<sup>93</sup> RICO,<sup>94</sup> and other crimes.<sup>95</sup> Insider criminal mis-

ing activity," but the provisions do not include bank fraud. See 18 U.S.C. § 1961(1)(B) (Supp. IV 1986).

The Supreme Court, however, limited application of § 1341. In 1974, the Supreme Court found no violation of that section when a fraudulent credit card scheme had been completed before mailings occurred. *United States v. Maze*, 414 U.S. 395 (1974). That interpretation narrowed the scope of § 1341; federal prosecutors "viewed *Maze* as a major impediment to using § 1341 in bank fraud prosecutions." Best, *supra*, at 25.

The Supreme Court again narrowed the scope of § 1341 in *McNally v. United States*, 107 S. Ct. 2875 (1987). The Court held that the mail fraud statute does not prohibit fraudulent schemes to deprive individuals of intangible rights. Since the *McNally* scheme involved intangible rights rather than a loss of money or property, the Court reversed *McNally's* conviction.

Justice Stevens noted in dissent that courts for decades have interpreted the mail fraud statute to prohibit schemes by public officials and private individuals to defraud others of intangible rights. *Id.* at 2883 (Stevens, J., dissenting). See, e.g., *id.* at 2883 n.1 (cases construing the mail fraud statute to prohibit schemes to deprive individuals of intangible rights). Congress agreed with the dissent and set aside the result of *McNally* in 1988. See Act of Oct. 21, 1988, Pub. L. No. 100-690, 102 Stat. 4508 (to be codified at 18 U.S.C. § 1346).

Although the *McNally* limitations no longer hinder future prosecutions for conduct that occurred after the effective date of § 1346, the *McNally* holding limits prosecutions for conduct in financial institutions prior to that date. The standard operating procedures of financial institutions are also limiting the application of § 1341. Institutions now frequently use private courier services, negating the applicability of the mail fraud statute. Dennis & Chafetz, *The Crime Control Act of 1984 and its Application to Financial Institutions*, 39 CONSUMER FIN. L.Q. REP. 23, 24 (1985). See also Best, *supra*, at 25.

Even with the judicial scope limitations and changing practices of institutions, mail fraud remains a significant prosecutorial weapon against misconduct in financial institutions. See, e.g., *United States v. Bates*, 852 F.2d 212 (7th Cir. 1988) (prosecution for mail fraud and misapplication of bank funds). See generally Rakoff, *The Federal Mail Fraud Statute*, 18 DUQ. L. REV. 771 (1980); Coffee, *The Metastasis of Mail Fraud: The Continuing Story of the "Evolution" of a White Collar Crime*, 21 AM. CRIM. L. REV. 1 (1983).

92 18 U.S.C. § 1343 (1982). The relevant portion of the statute provides the following:

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, transmits or causes to be transmitted by means of wire, radio, or television communications in interstate or foreign commerce, any . . . signals . . . for the purpose of executing such scheme or artifice, shall be fined not more than \$1,000 or imprisoned not more than five years, or both.

*Id.* Wire fraud combines with mail fraud to offer a "first line of defense" against fraud. Murakami, *White-Collar Crime: Fourth Survey of Law, Mail and Wire Fraud*, 24 AM. CRIM. L. REV. 623 (1987). See *supra* note 91.

93 Misconduct cases often involve charges of conspiracy. Such charges generally require four elements: "(1) an agreement; 2) to achieve an illegal goal; 3) with knowledge of the existence of the conspiracy, and with the intentional and actual participation in the conspiracy; and 4) an overt act in furtherance of the illegal goal." Branden, *White-Collar Crime: Fourth Survey of Law, Conspiracy*, 24 AM. CRIM. L. REV. 459, 462 (1987). A general federal conspiracy statute, 18 U.S.C. § 371 (1982), and substantive provisions in various federal statutes prohibit conspiracy. Financial institution misconduct cases may include conspiracy charges under either type of provision. Compare 18 U.S.C. § 371 (1982) (general conspiracy provision) and 18 U.S.C. § 1962(d) (1982) (RICO conspiracy provision). See, e.g., *United States v. Shively*, 715 F.2d 260 (7th Cir.) (prosecution for conspiracy and misapplication of bank funds), *cert. denied*, 465 U.S. 1007 (1983).

94 The Racketeer Influenced and Corrupt Organizations Act provides both criminal penalties and civil remedies for violations of its provisions. See 18 U.S.C. §§ 1963, 1964 (1982).

RICO prohibits a person from engaging in activities which affect interstate or foreign commerce, including: (1) using income received from a pattern of racketeering to acquire an interest in an enterprise; (2) acquiring or maintaining an interest in an enterprise through a pattern of racketeering; (3) conducting or participating in the affairs of an enterprise through a pattern of racketeering; and, (4) conspiring to commit any of the above offenses. Burke, *White-Collar Crime: Fourth Survey of Law, RICO*, 24 AM. CRIM. L. REV. 651, 657 (1987) (footnotes omitted). Federal prosecutors have brought charges of RICO violations in cases involving financial institution misconduct. See, e.g., *United States v. Butler*, Crim. No. 88-53-N (E.D. Va. Jan. 3, 1989) (denial of post-trial motions following conviction of wire fraud, bank fraud, bankruptcy fraud and racketeering). See generally U.S. DEPARTMENT OF JUSTICE, RACKETEER INFLUENCED AND CORRUPT

conduct cases often involve charges of several offenses, utilizing specific banking statutes and general federal statutes.<sup>96</sup>

Although prosecutors now have numerous federal criminal statutes applicable to misconduct in financial institutions, prosecution difficulties remain. Investigation and prosecution backlogs of insider misconduct cases present a significant problem.<sup>97</sup> An insufficient number of FBI investigators and U.S. attorneys in many districts contributes to those backlogs.<sup>98</sup> Additionally, the time required to investigate and prosecute each financial institution misconduct case has generally increased.<sup>99</sup> National offices emphasize such cases, but not all local FBI and U.S. attorney's offices follow that policy.<sup>100</sup> Some local law enforcement offices give financial institution misconduct cases lower priority, hindering effective prosecutions.<sup>101</sup>

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ORGANIZATIONS (RICO): A MANUAL FOR FEDERAL PROSECUTORS (1988); Blakey & Gettings, *supra* note 73 (general discussions of criminal RICO charges).

95 Prosecutors in cases of financial institution misconduct may bring charges under various other federal statutes, including the Travel Act, 18 U.S.C. § 1952 (1982 & Supp. IV 1986). That Act "prohibits travel in interstate or foreign commerce to further unlawful gambling, prostitution, extortion, bribery or arson, as well as illegal transactions involving liquor or narcotics." Shapiro, *White-Collar Crime: Fourth Survey of Law, Travel Act*, 24 AM. CRIM. L. REV. 735, 735 (1987).

96 Misconduct contributing to the failure of Penn Square Bank in Oklahoma resulted in charges of misapplication of bank funds, false entries in bank records, conspiracy and wire fraud. See *United States v. Patterson*, 827 F.2d 184 (7th Cir. 1987); *United States v. Patterson*, 782 F.2d 68 (7th Cir. 1986); *United States v. Lytle*, 677 F. Supp. 1370 (N.D. Ill. 1988); *United States v. Lytle*, 658 F. Supp. 1321 (N.D. Ill. 1987). For a description of the circumstances leading to the Penn Square Bank failure, see M. SINGER, FUNNY MONEY (1985) and P. ZWEIF, BELLY UP (1985).

For financial institution misconduct cases involving charges of several offenses, see *United States v. Copple*, 827 F.2d 1182 (8th Cir. 1987) (prosecution for misapplication of bank funds, false entries in bank records, false statements in loan applications, and conspiracy), *cert. denied*, 108 S. Ct. 1046 (1988); *United States v. Shively*, 715 F.2d 260 (7th Cir.) (prosecution for conspiracy and misapplication of bank funds), *cert. denied*, 465 U.S. 1007 (1983); see also *Corporate Crime at a Glance: Dallas Bank Fraud Task Force Prosecutions*, CORP. CRIME REP., Feb. 13, 1989, at 15.

97 The subcommittee found that "[f]inancial institution fraud and embezzlement cases, especially those involving \$100,000 or more are clearly overwhelming the criminal justice system." 1988 REPORT, *supra* note 49, at 140.

98 *Id.* The subcommittee highlighted several districts where bank fraud cases have become inactive because the district is experiencing a shortage of FBI investigators and prosecutors. Areas experiencing severe backlog problems include California, Texas, Florida and Wyoming. *Id.* at 141-44.

99 Bank fraud matters usually require a substantial review of documents and lengthy technical interviews. . . . Within the past few years, the amount of losses in bank fraud matters has increased drastically with a commensurate increase in the complexity of the investigation required. The number of major cases has also increased substantially, with the highest percentage of increases falling in the area of million dollar losses and bank failures. There has also been a significant increase in those cases involving bank officers and executives. The time required to investigate and prosecute those cases involving large losses, complex schemes, substantial document review, and bank executives . . . is dramatically longer than the typical teller defalcation case.

*Fraud and Abuse by Insiders, Borrowers, and Appraisers in the California Thrift Industry: Hearing Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations*, 100th Cong., 1st Sess. 429-30 (1987) [hereinafter *June 1987 Hearing*], quoted in 1988 REPORT, *supra* note 49, at 140.

100 1988 REPORT, *supra* note 49, at 140.

101 A California district exemplifies the problem. Prosecutors have done nothing regarding a completed FBI investigation and prosecutive recommendation concerning misconduct of former savings and loan association officers and directors. *Id.* at 145. "[T]he case inexplicably remains in limbo." *Id.* Similar cases are also receiving low priority treatment. *Id.*

### III. Efforts to Curb Insider Abuse and Criminal Misconduct

As Representative Fernand St. Germain noted at a hearing on insider misconduct, "the best laws we can devise are worthless unless we match our rhetoric with adequate resources to achieve an effective law enforcement, regulatory and legislative structure."<sup>102</sup> It is that cohesive structure that has been so elusive.

#### A. *The Mechanics of Detecting and Prosecuting Insider Abuse*

##### 1. Detection

Insider abuse or criminal misconduct in financial institutions can be detected in a variety of ways. Early detection usually occurs during a routine examination conducted by a banking agency.<sup>103</sup> Examiners find insider abuse difficult to detect because it is rarely evident from the reports they analyze. Additionally, the involved insider generally takes affirmative steps to conceal the abusive practices.<sup>104</sup> Banking agency examiners face a difficult task, yet they are the government's "only organized means of routinely detecting insider misconduct in financial institutions."<sup>105</sup> The frequency with which financial institutions are examined depends on the supervising agency.<sup>106</sup> Not all federal banking agencies meet their examination schedules.<sup>107</sup>

If insider misconduct is not detected early, the financial institution may fail. Investigators often uncover insider misconduct during an in-

<sup>102</sup> November 1987 Hearing, *supra* note 20, at 7 (statement of Representative Fernand J. St. Germain, Chairman, House Comm. on Banking, Finance, and Urban Affairs).

<sup>103</sup> Examinations focus on a broad range of factors and result in a rating of an institution's overall condition. An institution's condition is expressed as a "CAMEL" rating.

The acronym CAMEL represents the five categories in which banks are rated by examiners — Capital, Asset quality, Management, Earnings, and Liquidity. The composite rating represents the overall status of the bank and takes into account the ratings in all five categories.

A 1-rated bank is in the best of health while a 5-rated bank is very near failure.

OCC STUDY, *supra* note 20, at 3 n.2.

<sup>104</sup> 1984 REPORT, *supra* note 38, at 51.

<sup>105</sup> *Id.*

<sup>106</sup> The federal banking agencies examine financial institutions with varying frequencies. The FDIC policy requires annual examinations of institutions with CAMEL ratings of 3, 4, or 5. Institutions with CAMEL ratings of 1 or 2 are to be examined by the FDIC "as often as necessary," but at least every 36 months. November 1987 Hearing, *supra* note 20, at 150.

The Federal Reserve System examines state member banks which are experiencing problems twice each year. Healthy state member banks are examined by the Federal Reserve and, in some cases, a state banking agency annually. *Id.* at 293-94.

The Federal Home Loan Bank System policy requires an examination of healthy institutions every 18 months. Problem institutions are to be examined annually. *Id.* at 252.

The OCC does not have a policy requiring examinations at specified intervals. A supervisory strategy is determined for each institution. "The frequency of examinations is commensurate with the need for examination as determined on a case-by-case basis." *Id.* at 418.

<sup>107</sup> The FDIC failed to meet its examination schedule for the majority of problem banks. 1988 REPORT, *supra* note 49, at 63. The agency conducted timely examinations on 75% of healthy banks. *Id.*

Because of the OCC examination policy, *see supra* note 106, statistics on OCC schedules are unavailable. The Federal Home Loan Bank System and the Federal Reserve System are meeting their established examination schedules. November 1987 Hearing, *supra* note 20, at 207, 294.

Various factors can prevent an agency from performing a scheduled examination. In the 1988 Report, the subcommittee highlighted inadequate examiner staffing levels as a significant problem. 1988 REPORT, *supra* note 49, at 62-74. Insufficient examiner compensation contributed to high examiner turnover rates, compounding the difficulties. *Id.*

vestigation following insolvency, whether or not the misconduct directly caused the failure. Efforts must be made to pursue the perpetrators of the fraud or misconduct regardless of the time or method of discovery.

## 2. Investigation and Prosecution

A financial institution examiner records suspected insider abuse on the examination report and informs the institution's management of the suspected activities.<sup>108</sup> The banking agency may pursue civil enforcement actions at that time.<sup>109</sup> When criminal activity is suspected, the examiner requests the institution to make a criminal referral to the Justice Department. If the institution fails to submit a referral or if the examiner feels that the activity is sufficiently "serious," the examiner will make an agency referral.<sup>110</sup> United States attorneys, utilizing investigative help from the FBI, decide if prosecution is appropriate.<sup>111</sup>

Misconduct investigations also occur when a financial institution becomes insolvent. Those investigations proceed at the same time the appropriate banking agencies are taking action concerning the institution's financial problems. An attorney who has served as fee counsel for the FSLIC describes the typical environment at an institution closed because of insolvency:

When an institution is closed you have a multitude of forces coming together in usually what is a period of confusion. The association is thoroughly [sic] padlocked; you have Pinkerton or other guards coming in with boxes and identification badges and so on. You have a fee counsel who comes swooping in, often to an association with which he has never had any substantive prior contact. The FBI is often in the same position. The U.S. attorney is often in the same position. Outside fee counsel often don't know whether some preliminary criminal investigation is already ongoing. They have no idea. *There is no system in place to integrate all these forces.*<sup>112</sup>

The activities at insolvent institutions do not reveal a coordinated detection and investigation effort.

Problems exist throughout the entire detection, referral and prosecution system. Although the banking agencies no longer use different and sometimes inadequate referral forms,<sup>113</sup> they often delay submitting

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108 1984 REPORT, *supra* note 38, at 82.

109 See *supra* notes 55-58 and accompanying text.

110 1984 REPORT, *supra* note 38, at 82. Similar referral processes are followed at each federal banking agency. The regional or district office legal staff reviews the examiner's findings. If the evidence warrants referral, the legal staff sends a criminal referral to the U.S. attorney and a copy to the FBI. *Id.*

111 *Id.* at 83.

112 *June 1987 Hearing, supra* note 99, at 377-78, quoted in 1988 REPORT, *supra* note 49, at 99.

113 Prior to 1984, each banking agency used a different referral form. Important information was often omitted. 1984 REPORT, *supra* note 38, at 85-87. The Interagency Bank Fraud Working Group, see *infra* notes 125-27 and accompanying text, designed a uniform criminal referral form which includes all necessary information. 1988 REPORT, *supra* note 49, at 92. All federal banking agencies and most financial institutions now use the uniform referral. *Id.*

criminal referrals until after an institution has closed.<sup>114</sup> The agencies keep poor records of the referrals actually submitted and they rarely check on the status of the referrals unless the U.S. attorney or the FBI requests assistance.<sup>115</sup> Delays in prosecution,<sup>116</sup> exacerbated by a lack of cooperation from the banking agencies, further hinder a timely attack on insider misconduct. Banking agencies and law enforcement divisions have failed to demonstrate a concerted effort to detect, investigate and prosecute insider abuse.<sup>117</sup>

### B. Congressional Recognition of Problems

Increasing financial institution failure rates and the uncoordinated response detailed above drew the attention of Congress. The Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Committee on Government Operations targeted insider abuse and criminal misconduct in financial institutions for hearings in 1983 and 1984.<sup>118</sup> Because the banking agencies compiled no statistics on the effects and costs of insider misconduct, the subcommittee conducted an in-depth study of bank and loan association failures.<sup>119</sup> The study revealed a "deeply disturbing picture of a banking industry that suffers too many failures due to insider fraud, a bank supervisory system that frequently fails to detect, investigate or penalize such fraud, and a law enforcement system that frequently fails to prosecute it."<sup>120</sup> The 1984 Report recom-

114 1988 REPORT, *supra* note 49, at 94. Delays in making criminal referrals harm investigative efforts. When San Marino Savings & Loan failed, requiring \$260 million from the FSLIC, the agency did not notify the FBI when examiners first uncovered suspected fraud.

[T]he FBI's investigation shows that the agency had notice of possible criminal fraud almost two years before the institution failed. Rather than refer the case to the FBI, or even compare quarterly audits, the regulatory agency did not make a referral until the institution closed. The delay created severe document control problems and made a complex investigation even more difficult.

June 1987 Hearing, *supra* note 99, at 369-70, quoted in 1988 REPORT, *supra* note 49, at 96. United States attorneys indicate that the effectiveness of their actions would be greatly increased if FBI agents were involved in the investigation before the institution closed, or at least at the time of the failure, rather than later. 1988 REPORT, *supra* note 49, at 94.

115 1984 REPORT, *supra* note 38, at 83. Simply passing information along does not complete a referral. The referral process "extends to agencies' promoting and monitoring referrals they have already made." *Id.* Other government agencies, such as the U.S. Postal authorities and the Securities and Exchange Commission, actively follow up on their referrals. *Id.* at 83-84.

116 See *supra* notes 97-101 and accompanying text.

117 Coordination problems are "compounded by the simple fact that civil and criminal jurisdiction and the decision making process are independently exercised by [the banking agencies] on the civil side and [by the Department of Justice] on the criminal area." June 1987 Hearing, *supra* note 99, at 386, quoted in 1988 REPORT, *supra* note 49, at 99.

An FSLIC fee counsel noted that coordination between banking agencies and law enforcement offices needs improvement. "[I]t is our experience that such coordination is random and *ad hoc*, at best, and at times leads to an assumption by both sides that the other is taking care of the problem with the end result of nothing being done." *Id.*

118 See *Federal Response to Criminal Misconduct by Bank Officers, Directors, and Insiders (Part 2): Hearing Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations*, 98th Cong., 2d Sess. (1984); *Federal Response to Criminal Misconduct by Bank Officers, Directors, and Insiders (Part 1): Hearing Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations*, 98th Cong., 1st Sess. (1983).

119 1984 REPORT, *supra* note 38, at 4. The subcommittee studied the 105 bank and loan association failures that occurred between January 1980 and June 1983. *Id.* The subcommittee also surveyed certain criminal referrals and banking agency documents. *Id.* at 5.

120 *Id.* at 5.

mended various actions to be taken by the banking agencies, the Justice Department, and Congress.<sup>121</sup>

Because of the steadily increasing failure rates of financial institutions, Congress in 1987 again focused on the adequacy of the federal response to insider abuse and criminal misconduct.<sup>122</sup> The 1988 Report, based on the findings of those 1987 hearings, revealed improvements in certain areas, such as communication on the national level.<sup>123</sup> Deficiencies remain in the use of enforcement actions and interagency coordination.<sup>124</sup>

### C. *Recent Efforts to Curb Insider Misconduct*

Since the subcommittee's initial report in 1984, further attempts have been made to curb insider abuse and criminal misconduct. The Interagency Bank Fraud Working Group increased communication, at least on the national level.<sup>125</sup> Members of the group meet monthly; they have worked on specific recommendations made in the 1984 Report and they have shared information on current abusive schemes.<sup>126</sup> The group's work reflects progress toward a coordinated effort, but the federal banking agencies seem more willing to rely on the interagency group than to take action themselves.<sup>127</sup> An effective attack on insider abuse and criminal misconduct in financial institutions requires a determined approach within each agency and interaction among agencies on more than a national level.

Efforts in two geographic areas demonstrate such a comprehensive approach. An interagency task force in Illinois, the Bank Regulators' Forum, attempts to improve communication among regulatory agencies, in-

121 *See id.* at 17-25.

122 *See November 1987 Hearing, supra* note 20; *June 1987 Hearing, supra* note 99.

123 *See* 1988 REPORT, *supra* note 49, at 120-21.

124 *See supra* notes 61-70 & 112-17 and accompanying text.

125 The Working Group consists of representatives from the federal banking agencies (FDIC, FHLBB, Federal Reserve, OCC, and the National Credit Union Administration), the FBI, the Criminal Division of the Department of Justice, and the Farm Credit Administration. 1988 REPORT, *supra* note 49, at 120.

126 *Id.* at 120-21. The Working Group has addressed several recommendations given in the 1984 Report. The group developed a uniform criminal referral form. To aid communication, the group compiled and distributed to financial institutions lists of banking agency personnel responsible for criminal referrals, investigations and prosecutions. *Id.* at 120. The group also initiated the Significant Referral Tracking System (SRTS), a computer system designed to track certain criminal referrals both from financial institutions and banking agencies. *Id.* at 122. (The SRTS is not yet fully operational and it contains serious defects.) *Id.* at 122-25.

The Working Group developed guidelines to be issued by each agency as required by the amended bank bribery statute. Efforts of the group have also led to the Justice Department's increased emphasis on cases involving misconduct in financial institutions. *Id.* at 120.

127 *Id.* at 121. As Chairman Barnard of the subcommittee noted,

[a] task force, to me, is a body that gets in there and gets the job done; and I will be very honest with you, I am very disappointed. I don't see the meetings taking place like they should be. I just wonder if it's nothing but window dressing. . . . We haven't seen any dramatic actions, even in the changes in the laws. What little change in the laws that have come about to strengthen the criminal prosecution system and detecting crime has come from . . . Congress.

*June 1987 Hearing, supra* note 99, at 178-79, quoted in 1988 REPORT, *supra* note 49, at 121.

vestigative agencies, and the U.S. attorney's office.<sup>128</sup> The Bank Regulators' Forum schedules meetings approximately every two months where members discuss "mutual concerns," including criminal referrals made by the banking agencies and interpretations of various statutes.<sup>129</sup>

Another local effort involves a task force concentrating on investigating and prosecuting misconduct in the large number of recent financial institution failures in Texas. In Dallas, the Savings and Loan Fraud Task Force consists of attorneys, FBI agents, FHLBB examiners and Internal Revenue Service agents.<sup>130</sup> The task force "examine[s] the interconnections among a network of thrift owners, officers, and directors and their key borrowers."<sup>131</sup> Staff shortages and other difficulties have hindered the effectiveness of this task force,<sup>132</sup> but the group illustrates a possible approach to a regional problem. According to Attorney General Richard Thornburgh, the Dallas task force provides "an example of the kind of action that can be taken."<sup>133</sup>

Both types of task forces provide opportunities for the communication necessary to efficiently attack insider abuse and criminal misconduct in financial institutions. Such insider misconduct does not present a unique need for interagency coordination. Abusive and criminal activities in financial institutions, like organized crime,

encompass, geographically and statutorily, the entire spectrum of enforcement and prosecutorial jurisdiction. In order to break up the criminal organizations, cooperation of all agencies concerned is essential. A law enforcement system is needed which provides for some form of central direction and coordination and yet which allows for the advantages of specialization.<sup>134</sup>

The task forces in Illinois and Dallas meet those requirements. The Bank Regulators' Forum addresses interagency coordination from a routine operations perspective while the Savings and Loan Fraud Task Force illustrates a framework to coordinate regional problems.

Additional groups, with appropriate modifications, should be modeled after those in Illinois and Dallas. Groups similar to the Bank

128 Anton R. Valukas, U.S. Attorney for the Northern District of Illinois, formed the Bank Regulators' Forum in 1984 after observing a severe lack of communication in a bank fraud case involving insiders at institutions supervised by the FDIC, the FHLBB, and the OCC. 1988 REPORT, *supra* note 49, at 125-26. The Bank Regulators' Forum includes representatives from the FDIC, the FHLBB, the OCC, the FBI, the Postal Inspection Service, the U.S. attorney's office, the state commissioner of banks and the state commissioner of savings and loan associations. *Id.* at 126.

129 1988 REPORT, *supra* note 49, at 126.

130 The task force includes "8 prosecutors from the Fraud Section [of the Justice Department], 2 assistant U.S. attorneys, 1 special assistant U.S. attorney (a FHLBB attorney), numerous FHLBB examiners, 20 FBI agents and 5 IRS agents." 1988 REPORT, *supra* note 49, at 127.

131 Kahler, *supra* note 76, at 8, col. 1.

132 Zipser & Harlan, *The Fraud Patrol: Flashy Federal Posse Pursuing S & L Abuses Bungles Efforts in Texas*, N.Y. Times, Feb. 10, 1989, at 1, col. 1. "Budget cuts, low morale, and ineffective strategy have plagued" the Dallas task force. *Id.* The force has not operated with a separate budget. Most of the attorneys assigned to the task force continue to have other duties and few of the investigators possess experience in "pursuing labyrinthine paper trails." *Id.*

133 *Id.* For a list of Dallas task force prosecutions, see *Corporate Crime at a Glance: Dallas Bank Fraud Task Force Prosecutions*, *supra* note 96.

134 *The Strike Force: Organized Law Enforcement v. Organized Crime*, 6 COLUM. J. L. & SOC. PROBS. 496, 497-98 (1970) (footnote omitted).

Regulators' Forum should meet regularly in other cities across the country. The banking agencies generally agree that such groups would assist efforts to halt insider abuse and criminal misconduct. Unfortunately, the agencies have not all expressed a willingness to work toward the formation of local groups. The FDIC recommends forming the groups but refuses to actively organize local groups.<sup>135</sup> The Federal Reserve Board also prefers not to be involved with organizational work.<sup>136</sup> The OCC advocates forming such local groups and has pledged its support.<sup>137</sup>

#### IV. Conclusion

Insider abuse and criminal misconduct have contributed to a significant number of recent financial institution failures. Those insider activities drain millions of dollars each year from federal deposit insurance funds and weaken the banking system. American taxpayers are bearing not only the burden of banking industry losses, but also the burden of the industry's insider misconduct. Civil actions and criminal sanctions could place liability on the wrongdoers, but federal banking agencies and law enforcement divisions have been unable to coordinate an effective attack against insider misconduct in financial institutions. Billions of dollars in losses, combined with intangible damage and an inability to stop the harm, present a "crucial point or situation in the course of things."<sup>138</sup> That is a crisis.

The existence of a crisis does not signal the end of the banking system. Rather, the situation illuminates the critical need for action. Statistics demonstrate that the current attack on insider misconduct is failing along with the financial institutions. President Bush noted that "[f]or the future, we will seek to achieve a safe, sound and profitable banking system."<sup>139</sup> To achieve that goal, federal banking agencies must all demonstrate a serious commitment to eradicate insider abuse and criminal misconduct in financial institutions. Local banking agency and law enforcement offices must increase communication and coordination of efforts. The use of task forces corresponds to those needs. Such groups "concentrate personnel on a specialized task in order to focus and coordinate investigations and prosecutions on a targeted area."<sup>140</sup> Increased activity by the existing national group and expansion of local groups

<sup>135</sup> 1988 REPORT, *supra* note 49, at 128. The FDIC points to the U.S. attorneys' offices as the appropriate organizer of local groups. *Id.*

<sup>136</sup> *Id.* at 129. The Federal Reserve Board placed responsibility for coordinating local communication on local FBI and U.S. attorney offices. The Board advocated that the law enforcement offices organize networks using contact lists, "eliminating the need to convene, on a formal basis, a local level working group or task force." *November 1987 Hearing, supra* note 20, *quoted in* 1988 REPORT, *supra* note 49, at 129.

<sup>137</sup> 1988 REPORT, *supra* note 49, at 129. "The OCC fully endorsed the concept and intends to explore how it could establish such groups on a local level." *Id.*

<sup>138</sup> BLACK'S LAW DICTIONARY 338 (5th ed. 1979).

<sup>139</sup> *President's News Conference on Savings Crisis and Nominees, supra* note 4.

<sup>140</sup> N. ABRAMS, *FEDERAL CRIMINAL LAW AND ITS ENFORCEMENT* 133 (1986).



would promote the communication and coordination necessary for the banking system to emerge intact from this crisis.

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